# H. VEBA UPDATE AND SAFE HARBOR RULES

## 1. Introduction

For the Service, the enactment of nondiscrimination standards for voluntary employees' beneficiary associations (VEBA's) in the Deficit Reduction Act of 1984 had the immediate effect of creating more problems than it resolved. While in theory the Service had a new and powerful tool to deny exemption to plans that discriminate in favor of highly compensated individuals, the lack of regulations to implement the new IRC 505(b) statute not only kept the Service from any prompt use of the nondiscrimination provisions, but also effectively required the suspension of most IRC 501(c)(9) applications until some guidance on the interpretation of IRC 505(b) was forthcoming.

Although IRC 505(b) regulations still have not been issued, safe harbor guidelines have been published in the Exempt Organizations Handbook (see IRM 7751, text 935). These guidelines are intended to allow EO specialists to process VEBA applications and issue favorable determination letters in cases where the safe harbor guidelines are satisfied and all other requirements of the IRC 501(c)(9) statute and the underlying regulations are met.

With the publication of the safe harbor guidelines, it is now possible to process many IRC 501(c)(9) applications. Further, IRM 7664 has been revised to allow field offices to issue adverse determinations where the requirements of regulations underlying IRC 501(c)(9) are not met. Applications that cannot satisfy the safe harbor guidelines, and yet do not run afoul of the regulations underlying IRC 501(c)(9), are to be referred to the National Office. (For a more complete discussion of cases to be referred to the National Office, see Topic G, p. 99). For field offices, this means that the longstanding suspense to which most VEBA applications had been relegated has ended.

We believe that the safe harbor guidelines create an opportunity to close out a substantial number of currently pending VEBA applications before the provisions of IRC 89, enacted in the Tax Reform Act of 1986, become effective. IRC 89 becomes effective 90 days after the publication of regulations to implement that section, but no earlier than taxable years beginning after December 31, 1987, and no later than taxable years beginning after December 31, 1988. The ultimate impact of IRC 89 is unclear, but it will certainly affect how the nondiscrimination rules are applied to health and group term life benefits.

This topic will discuss and update major issues arising in IRC 501(c)(9) determinations, and will give a general outline of the safe harbor guidelines.

## 2. Securing a Complete Application

VEBA determinations typically require extensive information from the applicant before a determination letter is issued. Among the most important subjects of inquiry are whether an employment-related common bond exists, whether all benefits are of a type permitted by the regulations, whether a small VEBA is controlled by persons who receive a dominant share of the benefits from the organization, and whether the plan (if subject to IRC 505(b)) discriminates in favor of highly compensated individuals.

Reg. 1.505(c)-IT (Q & A-4) lists the information that must be provided by an IRC 501(c)(9) applicant. A complete description of all benefits available to participants, as well as the terms and conditions of eligibility for membership in the VEBA and the terms and conditions of eligibility for each benefit must be provided. Every VEBA applicant must show what benefits are offered, to whom, in what amount, for what duration, and in what circumstances. There is no required format. The information may be entirely within one "plan document," in several different documents, or in the trust instrument or other organizational document. It must, however, be in writing, and must be sufficiently complete so that for each benefit offered it can be determined which persons are eligible recipients, what conditions trigger the payment or distribution of the benefit, whether and to what extent employees are offered the benefit upon different criteria or conditions, and how the amount of the benefit is calculated or determined. If any of this information is missing from the organization's application for exemption, the organization should be asked to furnish it.

Where benefits are provided through commercial insurance policies, copies of all such policies should accompany the application. If individual policies of insurance are provided to participants, single exemplar copies that are typical of policies generally issued to participants are acceptable if they adequately describe all forms of insurance available to participants. Life insurance policies other than group-term life insurance should be checked to verify that they are in the name of the VEBA rather than in the name of the employer.

As with any other applicant for exempt status under IRC 501(a), there must be an organization. Most applicants are trusts, but a VEBA may also take the form of a corporation, or of an unincorporated association with enough characteristics of a corporation to be described in Reg. 301.7701-2. The organizational document (trust document, articles of incorporation, etc.) must accompany the application. In all cases a VEBA applicant must be an organization that is a separate entity from the employer.

Further, because the IRC 505(b) nondiscrimination requirements prohibit discrimination in favor of highly compensated individuals, it may be necessary to know who the highly compensated individuals are, their salaries, the compensation received by lower paid employees, and to what extent, if any, lower paid employees are not afforded comparable coverage for any benefit. Generally, because all information submitted in support of a favorable ruling, including salary information, is open to public inspection, it is sensitive for most employers. Therefore, it should not be requested without some indication that it is necessary to resolve specific nondiscrimination issues that cannot otherwise be resolved by reference to the plan document and to other available information.

3. <u>Membership Composition</u>

The membership composition of a VEBA is governed by certain limitations:

a. There must be more than one participant. Rev. Rul. 85-199, 1985-2 C.B. 163.

b. There must be an employment-related common bond, within which at least 90 percent of the total membership (on one day of each quarter of the taxable year) must be employees. Reg.1.501(c)(9)-2(a)(1).

The employment-related common bond requirement was discussed in the 1986 CPE, pp. 151-155. Generally, the requirement can be met in a number of ways and depends upon the facts and circumstance of each case. The regulations provide several methods that will clearly satisfy the employment-related common bond requirement. These include a membership defined by reference to:

1. a common employer

2. affiliated employers

The affiliation rules of IRC 414(b), (c), (m) and (n) are used to establish affiliation. See 1986 CPE at 152. GCM 39554 (9-8-86) considers the issue whether an insurance company, its wholly-owned subsidiaries, and its general agents are "affiliated employers" whose employees meet the employment-related common bond requirement. It concludes that the insurance company and its wholly-owned subsidiaries are affiliated employers, but that the general agents are not subject to the necessary control and close supervision to establish an affiliation with the insurance company and its subsidiaries.

3. a labor union or one or more collective bargaining agreements

4. employers in the same line of business in the same geographic locale. See 1986 CPE, pp. 154-155. The Service considers employers to be in the same geographic locale if they are located in the same state, metropolitan statistical area (MSA), or consolidated metropolitan statistical area (CMSA).

Since the 1986 CPE Topic was written, there has been a significant development involving the geographic locale limitation. In Water Quality Association Employees' Benefit Corporation v. U.S., 795 F.2d 1303 (1986), the Seventh Circuit reversed the District Court and held invalid the requirement of Reg. 1.501(c)(9)-2(a)(1) that organizations composed of employees of several unaffiliated employers must share the same geographic locale. The court found no basis in the statute for the geographic locale limitation.

Although the Water Quality Association position is now the law in the Seventh Circuit (i.e., in Illinois, Indiana, and Wisconsin), the Service continues to enforce the geographic locale restriction of Reg. 1.501(c)(9)-2(a)(1) and will litigate its position in other circuits. As stated in the preamble to the 1981 regulations, the two rationales for maintaining the restriction are:

1) To prevent nationwide IRC 501(c)(6) associations from using VEBA's to avoid the imposition of unrelated business income tax. If, for example, a nationwide IRC 501(c)(6) association provides group term life insurance to its members, it would be subject to UBIT. By creating a VEBA to accomplish the same end, the IRC 501(c)(6) organization, if the geographic locale restriction can be bypassed, could avoid UBIT because the provision of group term life insurance to its members is directly related to the exempt purposes of a VEBA.

2) To prevent insurance companies from using VEBA's as tax-exempt vehicles to market insurance throughout the country in a manner that would

undermine those provisions of the Code covering the income tax treatment of insurance companies.

One geographic locale limitation case is now pending outside the Seventh Circuit and the Service will litigate others in order to establish judicial support for the regulation. Thus, EO specialists should continue to enforce the geographic locale restriction for organizations outside of Illinois, Indiana, and Wisconsin.

4. Low Membership VEBA's

As noted above, a VEBA must have more than one member. There are no other restrictions on the size of IRC 501(c)(9) organizations. However, in cases involving VEBA's containing a small number of participants, the Service is aware of a number of instances where the plan appears to be geared toward providing one or more principal officers with the potential of obtaining a dominant share of the value of the benefits. Because such situations may result in inurement of VEBA assets in favor of a few principal officers, IRM 7664.31:(9)(a) provides that applications should be referred to the National Office where:

a) participation is more than one and fewer than 20 persons, and

b) a dominant share of the total aggregate benefit is available to the owner, family members, or officers of the sponsoring businesses.

Such applications should be referred to the National Office regardless of whether benefits are calculated on the basis of a uniform percentage of compensation.

The potential for inurement in such situations is illustrated by Sunrise Construction Company, Inc v. Commissioner, 52 T.C.M. 1358 (1987), a case involving taxable years that predated the provisions of the Deficit Reduction Act of 1984. The employer set up a trust that offered employer-funded life benefits equal to three times employee compensation and disability benefits that equalled employee compensation for the employer's four employees. For the trust's first two taxable years, the employer contributed $520,000, of which $46,515 was expended for the purchase of term life insurance. The totals of the life benefits for which employees were eligible were as follows:

| | |
|---|---|
| Company President: | $ 450,000 |
| Wife: | $ 58,300 |
| Employee A: | $ 35,000 |
| Employee B: | $ 40,022 |

Upon termination, the plan provided that residual assets would be applied in one or a combination of the following ways: (a) to provide life, sick, accident or other benefits; or (b) to provide cash to participants in proportion to compensation.

The Tax Court concluded that the plan was, in effect, operated for the company president's own benefit, and the incidental coverage of other employees was "merely a cost of securing the anticipated tax-exempt status." The court cited three factors in reaching this conclusion:

a) the large contributions in relation to premiums actually paid out;

b) the fact that the company president's investments of the trust assets were speculative, did not appear to be an appropriate exercise of fiduciary duty, and appeared to accommodate special interests of the company president; and

c) following the IRS denial of exempt status, assets of the trust were returned to the employer without regard to the plan documents.

The potential for use of low membership VEBA's to benefit officers has doubtless been lessened by the 1984 enactment of IRC 419, 419A, and 4976. These provisions effectively put a cap on employer contributions for employee welfare benefit plans, impose unrelated business income tax on overfunded benefit accounts, and impose a 100% excise tax on the employer on amounts reverting to it from the VEBA. These would serve as additional tools for the Service if a case similar to Sunrise Construction Company should arise today.

5. Qualifying Benefits

Under Reg. 1.501(c)(9)-3, a VEBA must provide life, sick, accident, or other benefits. The regulations interpret the phrase "other benefits" to mean benefits that are similar to life, sick, or accident benefits. Benefits that are not qualifying benefits under the regulations may not be provided except in de minimis amounts.

A challenge to Reg. 1.501(c)(9)-3 was made in Anesthesia Service Medical Group, Inc., Employee Benefit Protective Trust v. Commissioner, 85 T.C. 1031 (1985). In that case, a professional corporation set up a trust to insure its physician employees against malpractice claims. In claiming to be a VEBA, it asserted that Reg. 1.501(c)(9)-3(f), which lists malpractice insurance as a nonqualifying VEBA benefit, was an invalid interpretation of the IRC 501(c)(9) statute. The organization claimed that the phrase "other" benefits in the IRC 501(c)(9) statute should not be limited to benefits that are similar to life, sick, and accident benefits. However, the Tax Court rejected this challenge to the regulations, noting that in the summary of "present law" with respect to VEBA's in the Senate Finance Committee and Joint Committee on Taxation Reports concerning the Tax Reform Act of 1984, the prohibition of the regulations against malpractice insurance was specifically mentioned. The court noted that Congress was consequently well aware of the provision, had characterized it as existing law, and did not attempt to change it. The court concluded that Congress believed the regulations to be a reasonable interpretation of the law. This decision was upheld on other grounds in the Ninth Circuit after the taxpayer had dropped its claim to VEBA status. Anesthesia Service Medical Group, Inc. v. Commissioner, 825 F.2d 241 (1987).

Another challenge to the regulation occurred in Canton Police Benevolent Association of Canton, Ohio v. U.S., 658 F. Supp. 411 (D.C., N.D. Ohio, East Div., 1987). The organization provided a retirement dividend to its members upon separation from employment with the Canton Police Department after 20 years of service. It argued that the retirement dividend was a qualifying "other" benefit under the IRC 501(c)(9) statute. However, the court held that Reg. 1.501(c)(9)-3(d), which defines "other benefits" to be those similar to life, sick, and accident, was a reasonable interpretation of the statute and in accordance with the rules of statutory construction. Revocation of IRC 501(c)(9) status was upheld.

The subject of qualifying benefits has been extensively discussed in earlier CPE texts. See 1982 CPE pp. 212-228; 1983 CPE pp. 70-72; 1984 CPE pp. 108-116. A summary of benefits that are qualifying and nonqualifying under the regulations was included in the 1986 CPE and is reprinted below:

QUALIFYING BENEFITS (ALL VEBA's)

Term Life Insurance
Group Whole Life Insurance (as defined in IRC 79)
Accidental Death and Dismemberment (AD&D)
Medical Dental Disability (both long and short-term)

Vacation Pay
Vacation Facilities
Recreational Expenses
Child-care
Job Readjustment Allowances
Income Maintenance Payments in Times of Economic Dislocation
Temporary Living Expense
Loans and Grants in Times of Disaster
Supplemental Unemployment Compensation (SUB) Benefits
Severance Pay (if provided in accordance with 29 CFR 2510.3-2(b))
Education or Training Benefits or Courses for Members
Personal Legal Services Payments (through IRC 501(c)(20) organizations only)
Any other benefit meeting the criteria of Reg. 1.501(c)(9)-3(b), (c), (d), or (e)

ADDITIONAL QUALIFYING BENEFITS FOR COLLECTIVELY BARGAINED VEBA's ONLY

Benefits provided in the manner permitted by paragraphs (5) et. seq. of section 302(c) of the Labor Management Relations Act. The only significant types of benefits referred to, for practical purposes, are

1) Educational or Training Benefits for Dependents of Members

2) Personal Legal Service Benefits (other than through an IRC 501(c)(20) organization)

3) Workmen's Compensation

NONQUALIFYING BENEFITS

Whole Life Insurance (nonqualifying under IRC 79)
Accident Insurance on Property
Homeowners' Insurance
Commuting Expenses

Malpractice Insurance
Loans (Other than in times of distress)
Savings facilities
Pensions
Annuities, payable at retirement
Stock Bonus or Profit-sharing Plans
Any other deferred compensation benefits
Dependent's Education (noncollectively bargained plans)
Supplemental Retirement Benefits

6. Miscellaneous Problems Not Involving Discrimination

Certain additional problems may occasionally arise under the IRC 501(c)(9) regulations. Several of these are listed below:

(A) Control by Membership

Reg. 1.501(c)(9)-2(c)(3) requires that a VEBA must be controlled either:

1) by its membership;

2) by independent trustee(s) (such as a bank); or

3) by trustees or other fiduciaries at least some of whom are designated by, or on behalf of the membership. Whether such control by or on behalf of the membership exists is determined with regard to the facts and circumstances of each case. However, Reg. 1.501(c)(9)-2(c)(3)(iii) provides that an organization will be considered controlled by independent trustees if it is an "employee welfare benefit plan" as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of Parts 1 and 4 of Subtitle B, Title I of ERISA.

We believe that the issue of control will seldom arise because, as a practical matter, most plans will be able to show that they are "employee welfare benefit plans", which are defined in section 3(1) of ERISA as any plan established or maintained by an employer or by an employee organization (or both) for the purpose of providing its participants or their beneficiaries with certain benefits.

The benefits that are acceptable for an employee welfare benefit plan under ERISA are virtually identical to those that are qualifying benefits under the IRC 501(c)(9) regulations.

Nevertheless, section 3(1) of ERISA was not made applicable to some plans, and consequently acceptable control under Reg. 1.501(c)(9)-2(c)(3) must be shown for the following:

1. governmental plans;

2. church plans under which no election under IRC 410(d) has been made;

3. plans maintained solely for complying with workers' compensation, disability insurance; or unemployment compensation laws;

4. plans maintained outside the United States primarily for the benefit of nonresident aliens; or

5. plans that are unfunded excess benefit plans as defined in section 3(36) of ERISA.

In American Association of Christian Schools Voluntary Employees Beneficiary Association Welfare Plan Trust v. U.S., 87-1 USTC 9328 (D.C., Ala. 1987), the court, after holding that the organization did not qualify for status under IRC 501(c)(3) or IRC 501(c)(4), held that exemption as an organization described in IRC 501(c)(9) was also unavailable on the grounds that the organization did not meet the control requirements of Reg. 1.501(c)(9)-2(c)(3). The creator of the fund is an association of fundamentalist Christian schools. The association's board of directors was initially chosen from among the pastors of the churches affiliated with the member schools. The welfare benefit plan of the association was created to provide benefits to employees of the associated schools.

The court noted that the control exercised by the employees over the welfare plan was virtually nonexistent, and that the trustees who controlled the plan were appointed by a self-perpetuating board of directors of the association. The court also noted that neither the schools nor their employees chose which pastors were to serve on the board. Although the organization argued that it was an "employee welfare benefit plan" within the meaning of section 3(1) of ERISA, the court ruled that the plan had failed to establish that it met and was subject to ERISA's requirements. In this respect, the Service position had been that the plan was not subject to ERISA because it was a church plan.

(B) Inurement

As in the Sunrise Construction Co. case cited earlier, issues of inurement in favor of officers, shareholders, and highly compensated employees may arise. Whether inurement is present that will cause denial of exempt status is a question to be determined with regard to all the facts and circumstances. Reg. 1.501(c)(9)-4 lists examples of situations that do and do not give rise to inurement, but the examples are not intended to be an all-inclusive list. Those situations listed in the regulations that result in inurement in favor of officers, shareholders, and highly compensated employees include:

1) The disposition of property to, or the performance of services for, a person for less than the greater of fair market value or cost (including indirect costs) to the organization, other than as a qualifying benefit.

2) The payment of unreasonable compensation to the trustees or employees of the organization.

3) The purchase of insurance or services for amounts in excess of fair market value from a company in which one or more of the organization's trustees, officers, or fiduciaries, has an interest.

4) The payment of disproportionate benefits to highly compensated personnel in relation to benefits received by other members. It should be noted in this respect that plans subject to IRC 505(b) (i.e., those that are not collectively bargained) cannot provide benefits that discriminate in favor of highly compensated individuals. Consequently, for all except collectively bargained plans, the same set of facts may provide two bases for denial: inurement resulting from disproportionate benefits, and discrimination. However, because regulations have not been issued to implement IRC 505(b), adverse rulings in such cases should be based primarily on the inurement rationale of Reg. 1.501(c)(9)-2(a)(2) and Reg. 1.501(c)(9)-4(b). Further, because the disproportionate benefits and nondiscrimination provisions tend to overlap, determinations specialists should subject all such cases to the safe harbor analysis of IRM 7751, text 935, and follow the procedures of IRM 7664.33 where disproportionate benefit issues are involved.

5) The payment to similarly situated employees of benefits that differ in kind or amount unless the difference can be justified on the basis of objective and reasonable standards adopted by the organization, or on the basis of standards adopted pursuant to a collective bargaining agreement. Reg. 1.501(c)(9)-4(b).

6) Upon dissolution of the organization, the distribution to officers, shareholders, or highly compensated employees of an employer that contributes to the organization of disproportionate benefits, or the distributions of unequal payment to similarly situated employees.

7) A provision in the governing document (or, in the absence of such a provision, if state law so provides) that upon dissolution the organization's assets will be distributed to the contributing employer or employers.

(C) Involuntary Membership

Reg. 1.501(c)(9)-1(b) requires that membership in a VEBA be voluntary. Reg. 1.501(c)(9)-2(c)(2) provides that membership is voluntary if an affirmative act is required by an employee to become a member rather than the designation as a member due to employee status. This regulation provides, however, that an association will be considered voluntary even if membership is required of all employees, provided that the employees do not incur a detriment as a result of membership. An example of such a detriment is a deduction from the employees' pay to finance a benefit. Likewise, membership will not be considered involuntary if it is required as a result of a collective bargaining agreement or as an incident of membership in a labor organization.

As a practical matter, we believe that there will be very few VEBA applicants that will fail on the grounds that they are not voluntary. Most-employer-sponsored VEBA's that we have seen do not finance benefits through deductions from employees' salaries. Nevertheless, involuntary membership was a secondary issue in Anesthesia Service Medical Group, Inc. v. Commissioner, discussed earlier. The Tax Court concluded that because all employees of the employer were members solely by reason of their employment, and because the physician employees incurred a detriment, membership was not voluntary within the meaning of the regulations. The detriment to the physicians that was found by the court was, first, a $10,000 per physician contribution by the employer medical group, a professional corporation, which reduced the amount of compensation that the medical group otherwise could pay the physicians; and second, the fact that the physicians agreed to salary cuts if trust funds were inadequate to pay claims. The court specifically noted that not all shareholder-employees had wished to adopt the plan, as the vote for it was not unanimous.

Whether the Anesthesia Service Medical Group rationale is viable outside of a professional corporation context is doubtful because contributions to a VEBA by an ordinary corporate employer would almost certainly not be considered to reduce employee compensation to the extent that an employee would be considered to suffer a detriment. In contrast, a professional corporation, whose shareholders are also its employees, will have reduced earnings on account of benefit payments and, as such, its shareholder-employees suffer a detriment through reduced distributive shares.

(D) Mergers, Terminations, Changes in Affiliation

On occasion, a new VEBA may be formed out of one or more pre-existing VEBA's as a result of a merger of employers or of unions, or as a result of a termination of an existing plan. Where an organization seeks recognition as an organization described in IRC 501(c)(9) as a result of such a merger, termination, or change in affiliation, IRM 7664.31:(9)(b) requires that the application be forwarded to the National Office.

7. Nondiscrimination Requirements

As discussed earlier, regulations under IRC 501(c)(9) contain prohibitions against disproportionate benefits on the grounds that their provision constitutes inurement. Further, eligibility for membership in a VEBA or for benefits cannot be limited in a manner that restricts membership or benefits to officers, shareholders, or highly compensated employees of a contributing employer. Reg. 1.501(c)(9)-2(a)(2)(i). These rules apply to all IRC 501(c)(9) organizations.

In an effort to tighten the disproportionate benefit restrictions applicable to IRC 501(c)(9) and IRC 501(c)(20) organizations, Congress enacted IRC 505 as part of the Deficit Reduction Act of 1984. IRC 505(a)(1) provides that to qualify as an organization described in IRC 501(c)(9) or (20), the nondiscrimination requirements of IRC 505(b) must be met. Under IRC 505(b)(1), a plan meets the requirements of IRC 505(b) only if:

1) each class of benefits under the plan is provided under a classification set forth in the plan that is not discriminatory in favor of highly compensated individuals; and

2) the benefits do not discriminate in favor or highly compensated individuals. The statute provides that life insurance, disability, severance pay, or supplemental unemployment compensation benefits will not fail the nondiscrimination requirement merely because the available benefits bear a uniform relationship to employee compensation.

Under IRC 505(b)(2), certain employees may be excluded from consideration. Because the Tax Reform Act changed the language of IRC 505(b)(2) to take effect with the effective date of IRC 89, care should be taken to ensure that the appropriate exclusions are made for the taxable years in question. IRC 89 takes effect for taxable years beginning after three months after the issuance of regulations implementing that section, but not earlier than taxable years beginning after December 31, 1987, and not later than taxable years beginning after December 31, 1988. Those employees that may be excluded under IRC 505(b)(2) (either version) are those with less than a certain minimum period of service with the employer or under a certain minimum age, part-time or seasonal employees, employees within collective bargaining units under which the benefits were the subject of good faith negotiations, and certain nonresident aliens.

Under IRC 505(b)(3), the nondiscrimination requirements of IRC 505(b)(1) are not applied to a benefit if a Code provision contains nondiscrimination rules for that benefit. In such a case, the Code provision applicable to the specific benefit is used in lieu of IRC 505(b)(1). Examples of benefits that are not subject to IRC 505(b)(1) are self-insured medical benefits (subject to IRC 105 before the effective date of IRC 89; subject to IRC 89 after the effective date); supplemental unemployment compensation benefits (IRC 501(c)(17); group legal services benefits (IRC 120); group term life benefits (subject to IRC 79 before the effective date of IRC 89; subject to IRC 89 after the effective date); dependent care assistance (IRC 129), educational assistance (IRC 127), and health and accident benefits (subject to IRC 89 after its effective date).

Regulations have not been issued to implement IRC 505(b), and most IRC 501(c)(9) applications were suspended until interpretative guidance could be furnished. However, as a result of safe harbor guidelines that were published in the Exempt Organizations Handbook (IRM 7751, text 935), we believe that most IRC 501(c)(9) applications can now be processed.

(A) Collectively Bargained Plans

Congress expressly excluded collectively bargained plans from the nondiscrimination provisions of IRC 505(b). The apparent rationale for their exclusion, although the committee reports were silent on the subject, was the greater likelihood of rank-and-file employee control over the selection and terms of benefits to be received. After the Service had seen several "sham" collective bargaining agreements that excluded rank-and-file employees, Congress added the explicit provision in the Tax Reform Act of 1986 that good faith bargaining was required between employee representatives and employers.

Under IRM 7664.33:(1)(a)(1), the Service will consider an organization to be part of a plan maintained pursuant to a collective bargaining agreement within the meaning of IRC 505(a)(2), if under the plan only members of the bargaining unit receive benefits. If nonbargaining unit members also receive benefits, the plan must be tested for discrimination under IRC 505(b) with respect to those individuals.

Although under IRC 505(a)(2) collectively bargained plans are not subject to IRC 505(b), they are subject to Reg. 1.501(c)(9)-2(a)(2) and 1.501(c)(9)-4(b) prohibiting disproportionate benefits in favor of officers, shareholders, and highly compensated employees. Under Reg. 1.501(c)(9)-2(a)(2)(ii)(B), a VEBA may permissibly exclude from membership, or limit the type or amount of benefits provided to, individuals within a collective bargaining unit, if there is evidence that the benefit or benefits provided to those in the bargaining unit were the subject of good faith bargaining. Likewise, under Reg. 1.501(c)(9)-2(a)(2)(ii)(C), restrictions or conditions on eligibility for membership or benefits may be imposed if they are determined through collective bargaining. Thus, as long as a VEBA excludes or restricts on the basis of issues negotiated in good faith in collective bargaining, it will generally not be considered to impose impermissible restrictions under Reg. 1.501(c)(9)-2(a)(2).

(B) The Nondiscrimination Safe Harbor Guidelines

On August 28, 1987, safe harbor guidelines were published in text 935 of the Exempt Organizations Handbook (IRM 7751). These guidelines are intended to allow a favorable determination to be made with respect to the IRC 505(b) requirements in the absence of regulations. The guidelines cover issues similar to those that arise under Reg. 1.501(c)(9)-2(a)(2) and Reg. 1.501(c)(9)-4(b), which cover impermissible restrictions and disproportionate benefits. If the safe harbor guidelines are satisfied, the requirements of Reg. 1.501(c)(9)-2(a)(2) and 1.501(c)(9)-4(b) will also be presumed to be satisfied.

1) General Rules

a) For favorable determinations only.

The safe harbor guidelines, if satisfied, are intended to allow a favorable determination to be made with respect to the nondiscrimination requirements of IRC 505(b). Failure to satisfy the safe harbor guidelines means only that a favorable determination will not be issued unless amendments to the plan are made to conform to the safe harbor guidelines. Under no circumstances may an adverse determination be made merely because the plan does not satisfy the safe harbor guidelines.

b) Each benefit must be tested.

A plan will not meet the nondiscrimination safe harbor unless each benefit offered by the plan conforms to the safe harbor guidelines applicable to that benefit.

c) A plan that provides benefits for employees of unrelated employers must be nondiscriminatory with respect to employees of each unrelated employer considered separately.

For example, a multi-employer trust composed of unrelated employers will meet the nondiscrimination safe harbor only if the safe harbor guidelines are satisfied with respect to each employer within the plan. Thus, if one employer within the trust includes only highly compensated individuals within that employer's benefit plan, or in any other way discriminates in favor of that employer's highly compensated individuals as to eligibility or as to the provision of any benefit, the safe harbor guidelines will not be met.

d) Related employers are considered a single employer.

Rules similar to those of IRC 414(b), (c), (m), and (n) are applied to determine whether employers are related.

e) The applicable safe harbor guidelines depend upon the type of benefit offered.

Differing safe harbor guidelines apply to:

-- income replacement benefits (IRM 7751, text 935.2)

-- benefits that are not income replacement benefits (IRM 7751, text 935.3)

-- benefits for which specific nondiscrimination rules are provided in IRC sections other than IRC 505. (IRM 7751, text 935.22 and 935.32). These include:

group term life benefits
self-insured medical benefits
commercially-insured health and accident benefits (after the effective date of IRC 89 only)
group legal services benefits
supplemental unemployment insurance
dependent care assistance
educational assistance

2) Income Replacement Benefits

Income replacement benefits are benefits designed to protect against a contingency that interrupts or impairs earning power. These are often provided as a fraction or multiple of employee compensation. Examples of income replacement benefits are life insurance and death benefits, disability benefits, and severance benefits. A sick pay or vacation pay benefit intended to replace earnings during the absence of an employee from work is also an income replacement benefit. Accidental death and dismemberment benefits (AD&D) are also considered income replacement benefits if provided as part of a commercially-insured life insurance program.

The safe harbor guidelines applicable to income replacement benefits generally provide that a benefit may be offered as a uniform percentage of compensation of employees covered by the plan. If highly compensated individuals are offered a benefit that is a greater percentage of compensation than that offered to lower paid employees, or if the benefit is offered with more favorable eligibility conditions or terms to highly compensated individuals, the safe harbor guidelines will not be met. Vacation pay benefits, however, may be provided on a basis that takes years of service into consideration, if provided under a formula that is not designed to provide disproportionate benefits to the prohibited group members. For example, if the class of employees entitled to the greatest vacation pay benefit is not composed primarily of prohibited group members, such plan will be considered nondiscriminatory.

Employees described in IRC 505(b)(2) may be excluded from consideration in applying the safe harbor guidelines, just as they may be excluded for purposes of IRC 505(b)(1). However, this does not apply to group term life benefits described in IRC 79, which are instead subject to the rules set forth in text 935.222 of IRM 7751.

A benefit need not be offered to all employees that are not excluded under IRC 505(b)(2). However, if a benefit is not offered to all non-excluded employees, the result cannot be to favor highly compensated individuals. See text 935.21:(10), (11), and (12) of IRM 7751 for an illustration of this principle.

(3) Benefits That are not Income Replacement Benefits

Benefits that are not income replacement benefits include any benefits that are not provided as a substitute for wages during a period of interruption or impairment of earning power. Examples include medical and dental benefits, child care facilities, educational expenses, and vacation facilities. Generally, the safe harbor guidelines applicable to such benefits differ from those applicable to income replacement benefits only in that the uniform percentage of compensation formula is not applied. Instead, all such benefits must be offered in equal amounts under equal terms, eligibility requirements and conditions, without regard to salary level, position, or ownership interest in the employer. A significant number of these benefits, however, are subject to non-IRC 505 nondiscrimination provisions, and consequently IRM 7751, text 935.32 should be consulted for the application of specific rules for self-insured medical, health and accident, group legal services, educational assistance, and dependent care benefits.

(C) Organizations That Do Not Meet The Safe Harbor

An organization that meets all the requirements of the IRC 501(c)(9) statute and regulations discussed earlier in this topic, but does not meet the nondiscrimination safe harbor, will ordinarily be given the opportunity to amend the plan to conform to the nondiscrimination safe harbor for each benefit.

1) If the organization does not agree to amend the plan to conform to the nondiscrimination safe harbor in all respects, the requirements of Reg. 1.501(c)(9)-2(a)(2) and Reg. 1.501(c)(9)-4(b) should be reviewed to determine whether the organization imposes impermissible restrictions or offers disproportionate benefits.

(a) If disproportionate benefits under Reg. 1.501(c)(9)-4(b) or impermissible restrictions under Reg. 1.501(c)(9)-2(a)(2) are imposed, an adverse determination may be issued on that basis. Adverse determinations should not cite, or be based upon, the safe harbor guidelines.

(b) If the organization does not impose impermissible restrictions under Reg. 1.501(c)(9)-2(a)(2), the application should be referred to the National Office under IRM 7664.31:(a)(c).

2) If the organization amends its plan to conform to the nondiscrimination safe harbor requirements, it is eligible for a favorable determination letter. However, the issue of whether a retroactive or a prospective determination letter is to be issued must still be resolved.

(a) If the organization has not actually paid out any benefits that do not meet the nondiscrimination safe harbor, it is eligible for exemption retroactive to the date of its formation, provided that the notification requirements of IRC 505(c) are met.

(b) If the organization has actually paid out benefits that do not meet the nondiscrimination safe harbor, it is eligible only for prospective exemption effective the date the plan is amended to conform to the safe harbor guidelines, provided that the organization agrees to such prospective exemption. See IRM 7664.33:(4). If the organization does not agree to prospective exemption, National Office referral is required. See IRM 7664.31:(9)(d).

8. <u>Notification Requirements</u>

Reg. 1.505(c)-IT requires that all IRC 501(c)(9) applications be filed by the later of February 4, 1987, or 15 months from the end of the month in which the organization was created. Otherwise, the organization will not be recognized as exempt for any date prior to the filing of the application. However, relief may be available under Reg. 1.9100-1. The procedures of IRM 7664.31:(5) should be followed (to the extent applicable to IRC 501(c)(9) organizations) when relief under Reg. 1.9100-1 is requested. See the Topic B in this text on Reg. 1.9100-1.

9. IRC 4976 Excise Tax on Disqualified Benefits

The Tax Reform Act of 1984 enacted IRC 4976 to provide a 100% excise tax on the amount involved for any disqualified benefit provided by an employer through a VEBA or other welfare benefit fund. The tax is imposed on the employer, and not upon the VEBA.

Temporary regulations implementing IRC 4976 were issued in January 1986. Under Reg. 54.4976-IT, Q & A 2, a disqualified benefit is:

> (a) any post-retirement medical or life insurance benefit provided with respect to a key employee (as defined in IRC 419A(d)(3)) through a welfare benefit fund, if a separate account is required to be established for the key employee under IRC 419(d) and the cost of the coverage is not charged against or paid from the separate account. A post-retirement medical or life insurance benefit provided with respect to a key employee will not constitute a disqualified benefit even though the benefit is not provided through a separate account, if the cost of the benefit is paid by the employer in the taxable year in which the benefit is provided and there is not (and there is not required to be) a separate account with an outstanding balance maintained for the key employee;
>
> (b) any post-retirement medical or life insurance benefit provided through a welfare benefit fund with respect to an individual in whose favor discrimination is prohibited unless the plan meets the nondiscrimination requirements of IRC 505(b) with respect to that benefit; or
>
> (c) any portion of the fund that reverts to the benefit of the employer.

As stated in the General Explanation of the Deficit Reduction Act of 1984 by the staff of the Joint Committee on Taxation, Congress enacted IRC 4976 because it was concerned that employers might maintain a plan that complies with the nondiscrimination requirements, and at the same time build up assets for a post-retirement life insurance benefit. During the period such assets are accumulating, the employer would benefit from the deductions received for contributions to the fund as well as from the tax-exempt status of the fund. At a later date, when benefits are to be paid, the plan might be changed to no longer comply with the nondiscrimination requirements. If this were to happen, simple loss of tax-exempt status or a denial of deductions for future contributions would not be a significant detriment for the employer. Likewise, loss of exempt status or deductions for future contributions because of a prohibited reversion would not be a meaningful sanction in the case of a fund that had ceased to exist. IRC 4976 acts as a more effective sanction upon an employer in those cases where loss of exemption or deductions for future contributions are insufficient deterrents.